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C O N F I D E N T I A L MANAMA 000053

SIPDIS

DEPARTMENT FOR EEB, NEA/RA, AND NEA/ARP
BAGHDAD FOR AMBASSADOR ERELI

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TAGS: ECON EFIN BA

SUBJECT: BAHRAIN FINANCIAL SECTOR SHOWING CRACKS

REF: MANAMA 2

Classified By: CDA Christopher Henzel for reasons 1.4 (b) and (d)

¶1. (C) Summary: Effects of the financial crisis are beginning to manifest in Bahrain's banking and finance sector. Many banks are facing capital shortages and the Central Bank is facing a possible "liquidity trap." Central Bank officials expect Bahrain to trail the U.S. economy by a year, and anticipate losses in the banking and finance sector to continue through at least 2009. End summary.

¶2. (SBU) Although only one bank headquartered in Manama)- Bank of Bahrain and Kuwait (BBK) -- is known to have had significant direct exposure to the U.S. sub-prime market, several banks posted large losses in 2008. Arab Banking Corporation (ABC) posted almost \$1 billion in write-downs in the first three quarters of 2008, and laid off 30 bankers, including the Director of Risk Management and the entire economic research and mergers departments. Several banks including Ahli United and ABC have closed or contracted their wholesale operations and are focusing on expanding retail operations which typically require less capital to operate. One of the only major banks to beat expectations in 2008 was Ithmaar Bank, an investment bank which has been moving to acquire holdings in other banks -- they acquired a 100% share of Shamil Islamic bank in 2007, and a 25.4% share of BBK in ¶2008. Ithmaar posted a profit of \$113 million in 2008.

¶3. (C) Real estate prices plunged in the final half of 2008, dropping almost 30%. Central Bank of Bahrain (CBB) Director of Banking Operations Sheikh Salman bin Isa Al Khalifa told Econoff that he anticipated real estate could fall as much as 50%, setting off another round of big write-downs. He said the decline in real estate values would likely hit the Islamic banking sector hardest since those institutions tend to have real estate-heavy portfolios. (Islamic finance accounts for about seven percent of Bahrain's financial sector assets. The Islamic sector has been the fastest-growing sector and has repeatedly outperformed the conventional banking sector both in terms of profit growth and return on equity.)

¶4. (C) Real estate agents have blamed the price decline on a liquidity shortage, noting that big new institutional investments have all but dried up, and long-term projects have been put on hold as investors pull out. Retail banks have responded to the liquidity shortage by limiting mortgages, auto loans, and personal credit while shifting their marketing strategy away from loans to attracting deposits. Sheikh Salman at the Central Bank expressed concern that this may be the beginning of a decline into a "liquidity trap" where banks are unwilling to lend, limiting the ability of the Central Bank to respond. The Bahraini economy appears to be trailing the U.S. by approximately 12-18 months, he said, and even once the U.S. economy turns

around, the situation in Bahrain could continue to decline
for at least another year.

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HENZEL